Liberate Supply

Testimony before the Subcommittee on Domestic Monetary Policy,
Technology, and Economic Growth
of the

Committee on Financial Services
of the
United States House of Representatives

At a hearing entitled
"Beyond the Tax Cut: Unleashing the Economy"

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Mr. Chairman, Members of the Committee:

My name is James K. Glassman. I am a resident fellow at the American Enteprise Institute for Public Policy Research in Washington, D.C., and host of www.TechCentralStation.com, which concentrates on issues of technology and public policy. I am also a senior consultant and chief columnist to Folio(fn), a financial services company that packages and markets portfolios for investors. My writing on financial and economic matters appears regularly in the Wall Street Journal, International Herald Tribune and other media, and I am co-author of *Dow 36,000*, a book on stock valuation. For six years, I was a columnist for the Washington Post. Prior to that, I was editor of Roll Call, the twice-weekly newspaper that covers this institution; publisher of two public affairs magazines, the New Republic and the Atlantic Monthly; and host of two television series, "Capital Gang Sunday" on CNN and "TechnoPolitics" on PBS.

My main area of academic interest is the nexus among technology, finance and public policy.

The message I bring you today is that the U.S. economy has slowed and that tax cuts and monetary easing are necessary but not sufficient to restore the rate of growth we experienced in the late 1990s. What is critical is that changes are made in regulatory policy to encourage a liberation of supply – a resurgence of output. I will give specific recommendations on how this can be accomplished. First, however, I will briefly review the state of the economy; offer observations on why it has slowed; and present an analysis on why it has grown with such strength over the past decades.

State of the Economy

The United States economy has slowed significantly in recent months. The growth in Gross Domestic Product (GDP), the nation's output of goods and services, fell from 5.6 percent in the second quarter to 2.2 percent in third quarter to 1.1 percent in the fourth. Retail sales and job growth are flat, unemployment is rising, the critical Purchasing Managers Index has dropped by one-fourth in the past year, a majority of banks has tightened credit requirements for businesses, and industrial production has dropped for five straight months.

The high-technology sector has been hit especially hard. For example, Cisco Systems, the giant Internet infrastructure provider, was increasing its revenues at a 70 percent pace as recently as November. But by February, sales were actually *down* from the previous year. "This is important," writes economist Brian Wesbury of Griffin, Kubik, Stephens & Thompson, Inc., who then quotes Alan Greenspan, the Fed chairman, as saying on March 27: "High-tech goods – semiconductors, computers, and LAN equipment…contributed two-thirds of the increase in manufacturing output between 1995 and 2000." Overall, electronic goods orders are off 4 percent over the past year. Meanwhile, the authors of a new study estimate that 80 percent of the remaining dot-com companies in the San Francisco Bay will collapse in the next year. Profit expectations for the companies of the tech-heavy Nasdaq have fallen 75 percent. We may already be living through the beginning of the first recession in 10 years; we will know for sure when the statistics are published in a few weeks.

The 1990-91 recession, which ran for nine months, was considered mild by historic standards. At its depth, the economy's output declined only 1.5 percent. Still, it is important to remember that even short and shallow recessions hurt. In the last recession, the unemployment rate rose from 5.4 percent to 7.8 percent (by the summer of 1992, after the recession had officially ended). It was not until December 1994 that unemployment returned to its pre-recession level. If we have a typical recession, three million Americans will lose their jobs. Also, even if we are not in a recession today, it feels like one. GDP growth has dropped from an average of about 4 percent to about 1 percent. That is roughly the equivalent of a decline from a GDP increase of 2 percent to a GDP *decline* of 2 percent.

Causes of the Slowdown

Today's slowdown has no single cause. These are the major culprits:

- **Fed rate hikes**. The Federal Reserve began raising interest rates in June 1999 with little sign of inflation. Instead, the central bank appeared to be reacting to high growth and to a buoyant stock market. The real, after-inflation, rate on federal funds, the overnight loans that the Fed targets, reached a peak of 5.1 percent in October 2000, the highest rate since September 1989 – a year before the last recession – constricting the flow of capital.

- **Tripling of oil prices**. Eight of the nine post-World War II recessions, including the last four, have been preceded by an oil shock. It is the rising oil price **plus** tighter Fed policy that tends to cause recessions, and this double whammy is present today as well.

- **The drag of high taxes and a gigantic surplus**. Federal tax revenues as a percentage of GDP last year were 20.6 percent – a level exceeded only twice in U.S. history, in 1944 and 1945. The surplus itself is a reflection of these high revenues flowing into Washington. Cash that could have been used for consumption or new private investment is instead being used to retire the bonds of investors who typically use the proceeds to buy more bonds. Retiring debt – especially with debt at such low levels (about one-third of GDP) is no way to spur an economy. (I respectfully refer the committee to my article, "The Joy of Debt" in the March 26, 2001, issue of The Weekly Standard.)

- **The end of the high-tech "enterprise zone."** The past year, especially, has seen increased government intervention in the economy, especially in the high-technology sector and federal and state mismanagement of the planned deregulation of telecommunications. A year ago, I argued that this change in political approach to high tech threatened a "regulatory recession." We may be in it. It is no coincidence that high-tech stock prices began their 60 percent slide at almost the same moment that the Justice Department asked a federal court to break up Microsoft Corp., the software company that is credited with igniting the computer revolution in the early 1980s. While the antitrust suit against Microsoft was instigated by its competitors, the result has been to damage the capital-raising ability of nearly every high-tech firm – and to encourage further interventions at federal, state and local levels, threatening to end the status of high tech as a kind of "enterprise zone," free from high taxes and onerous regulation. In telecommunications, the persistence of monopoly power in local markets has greatly deterred the rollout of broadband technology and deferred indefinitely much of the promise of the Internet.

Why the Economy Boomed

Before getting to the question of what must be done to reverse the slowdown, we need to examine why the economy has been so successful up to now. The U.S. is in the tenth year of an unprecedented expansion. Even if the recession did start in January, the economy will have grown a full year longer – without respite – than in any period since reliable statistics began to be gathered in the 1870s. The third-longest expansion (and the second-longest during peacetime) was the period that immediately preceded the brief 1990-91 recession. In other words, since July 1982, the GDP has increased consistently, with a nine-month exception. No economy in the world has seen such a boom in output and accumulation of wealth in so short a period.

Since World War II, there have been nine recessions in 56 years, but in the past 18 years there has been just one. Has the business cycle been repealed? That cycle works like this: Low unemployment and prosperity raise the demand for goods and services. This rising demand inevitably bumps up against supply, gets tangled in bottlenecks. With supply constrained, prices rise, and general inflation ensues. The Fed, whose job it is to prevent the depreciation of the dollar and to maintain financial stability, raises interest rates to whack down inflation. The economy slows and frequently goes into recession. Interest rates fall, the economy revives, and the cycle begins all over again. But in the 1980s and 1990s, this pattern did not hold. Strong growth – at times more than twice the post-war average -- was accompanied not by rising inflation but by relatively stable prices.

Why?

The reason is that the U.S. has been undergoing what I call a "liberation of supply." When demand rose, it did not bump up against supply constraints, so prices remained tame. In a broader sense, capital and the other tools necessary for an entrepreneurial expansion were all in place, so the economy boomed. What were the factors that liberated supply? Here are the primary ones:

- **The spread of free trade**. When bottlenecks occurred in this country, goods from other countries took up the slack. In addition, the U.S. has been helped by immigration (free trade in people, especially in high technology) so that labor shortages were milder than usual. And, at the same time, a financial revolution helped liberate capital and spread it around the world, with investors seeking the best place to deploy their funds – often, the United States, with its relatively accommodating business environment.

- **Lower tax rates and new regulatory policies**. Before Ronald Reagan's election in 1980, the top rate on income was 70 percent. It was cut 28 percent, but, even at today's top rate of 39.6 percent (which applies to nearly all decent-sized private proprietorships and partnerships), it is far lower than in the 1970s (though still too high). Low taxes encourage more work and investment – that is, more supply. At the same time, the government began a series of deregulatory measures, beginning with transportation in the Carter Administration and extending to energy and telecommunications. This work is far from done, but the change helped remove supply constraints.

- **Better monetary policy**. The Fed has learned a lot since the 1930s, when three successive chairmen presided over tight-money policies that exacerbated the Depression. Paul Volcker, with the backing of President Reagan, had the courage to ring inflation out of the economy, and Alan Greenspan has continued those policies. The next Fed chairman can be expected to do the same, keeping interest rates low and encouraging investment and the liberation of supply.

- **The high-tech revolution**. The advent of inexpensive, powerful networked computers has boosted productivity – the main component of economic growth. From a rate of less than 1 percent in the 1970s, productivity averaged 1.7 percent between 1982 and 1995, and a remarkable 2.9 percent over the past five years. Very simply, productivity means more output for the same input – that is, more supply. Why? Greenspan's own major contribution has been to recognize that information technology not only enhances the knowledge of businesses, it also reduces uncertainty – so that companies do not have to maintain redundancies in their workforce, inventories or plant and equipment, thus reducing inputs. As he said in a speech at Boston College on March 6, 2000:

> Before the quantum jump in information availability, most business decisions were hampered by a fog of uncertainty. Businesses had limited and lagging knowledge of customers' needs and of the location of inventories and materials flowing through complex production systems. In that environment, doubling up on materials and people was essential as a backup to the inevitable misjudgments of the real-time state of play in a company…. [Now,] fewer goods and worker hours are involved in activities that, although perceived as necessary insurance to sustain valued output, in the end produced nothing of value.

What Is to Be Done?
Tax Cuts and Rate Cuts

But lately, the liberation of supply has stalled. New bottlenecks and shortages have developed that threaten not simply to reduce growth but to raise prices as well, raising the specter of stagflation for the first time since the 1970s.

Two obvious steps are now being taken.

First, the Federal Reserve's Open Market Committee has reduced its target for the fed funds rate – from 6.5 percent to 5 percent. The Fed is likely to continue cutting through the spring and early summer, and a typical easing cycle would bring the rate to 3.5 percent, which should be enough to revive the economy eventually – though, as Milton Friedman long ago recognized, it takes six to nine months for rate changes, in either direction, to flow through the economy. It was not until last fall that we began to feel the impact of the rate hikes that started in 1999.

Second, Congress has begun action on President Bush's plan to cut taxes a total of $1.6 trillion over ten years. While this hearing is titled, "Beyond the Tax Cut: Unleashing the Economy," I want to emphasize the importance of significant tax relief. A short-term cut of $60 billion, as was recently proposed by some Senators, will give the economy little stimulus. Current GDP is $10 trillion. If half of the one-time tax rebate is consumed and the rest saved (a decent assumption), then increased consumption will represent just 0.3 percent of GDP. Or think of it this way: The CBO expects that tax revenues in fiscal 2001 will total $2.2 trillion. A rebate of $60 billion amounts to less than 3 percent of that figure. Even after such a rebate, tax revenues will still rise – assuming that the relief occurs wholly within the fiscal year – by some $41 billion for 2001, applying more drag to a declining economy.

If fiscal policy is to be used for short-term stimulus, then it must be far more aggressive. The surplus is expected to be $281 billion for fiscal 2001. A tax rebate of half that amount, retroactive to the first of the year and starting immediately, would have some sort of impact.

But such measures are diversionary and even counter-productive. Far more important for the long-term strength of the economy would be comprehensive relief in the form of reductions of marginal tax rates, across all brackets, as President Bush has proposed. Even if these reductions took place over time, they would immediately signal an important change to investors and consumers and would likely lead to more savings and investment and perhaps consumption as well. Also, in substance, cutting rates would spur entrepreneurship and investment by lowering the marginal cost of those activities.

A tax cut is the only sensible way to reduce the mounting surpluses, which will create a crisis of another sort by the year 2006, when the Congressional Budget Office forecasts that the federal government will accumulate $3 trillion in "uncommitted funds" – money that can't be used to pay down the debt because there will be no debt to pay down. Greenspan worries that these funds will be used to purchase private-company stocks and bonds – thus making the government a major player in the private markets and in corporate governance. Or the $3 trillion could, of course, be spent – since, judging from the budgets of the past two years, surpluses have loosened constraints on Congress and the White House.

Surpluses, in fact, are dangerous in times like these. My colleague at the American Enterprise Institute, the economist Kevin Hassett, pointed out in testimony Feb. 13 before the Ways and Means Committee that “the last time we approached a slowdown with restrictive fiscal policy, the economy responded to high surpluses and a general weakening in consumer demand by posting the steepest decline in real GDP in postwar history, dropping a whopping 10.3 percent (annual rate) in the first quarter of 1958. At the time, the surplus was about 1 percent of GDP.” Currently, it is forecast to be three times as high.

Regulatory Reform to Spur High-Tech Supply

But resuscitation will require more than interest-rate cuts and tax-rate cuts -- though they are absolutely necessary. It will require regulatory changes that liberate supply once again. Specifically, these steps should be taken:

1. **The U.S. needs to formulate a clear energy policy that concentrates on encouraging supply.** Currently, supply is being severely hampered by excessive environmental barriers to increased exploration for energy and by policies, such as “new source review,” that discourage the renovation of old refineries and utility plants and the building of new ones. We have neglected supply for ten years and are just now beginning to suffer the consequences. High technology requires energy, but supply constraints are putting the supply of energy in jeopardy. I recently returned from California, the heart of the nation’s high-tech economy, where rolling blackouts are wreaking havoc with production. The rest of the nation may follow this summer.

2. **The antitrust policy of the later years of the Clinton Administration should be changed to take into account the realities of high technology**. I am referring especially to two phenomena: that monopolies and near-monopolies tend to be short-lived since barriers to entry for competitors are low and information about new software and other innovations spreads quickly, and that high-tech monopolists and near-monopolists, with low (often *no*) marginal costs, have an incentive to *increase* production rather than restrict it, as monopolists of the past did. The antitrust suit against Microsoft was the seminal event that changed the relationship between government and high technology and frightened investors. The decision by the Justice Department to go after a breakup of Microsoft coincided almost precisely with the peak of the Nasdaq and the beginning of its decline of nearly two-thirds in value. As George Bittlingmayer recently concluded after a historical study in a paper titled “Regulatory Uncertainty and Investment: Evidence From Antitrust Enforcement” in The Cato Journal (vol. 20, no. 3): “The low investment of the late 1950s and early 1960s was due at least in part to a resurgence of aggressive antitrust and related initiatives interpretable as ‘anti-business.’ Some of the low investment of the 1970s may have had a similar origin.” Much the same is happening now to the high-tech

sector. Congress and the new administration have a chance to return to the course of the 1980s and most of the 1990s.

3. **The bottlenecks that are restricting the spread of broadband technology must be forced open**. The main problem is the lack of enforcement of the main piece of deregulatory legislation, the Telecommunications Act of 1996, which required the Bell monopolies to open up their systems to local competition as a condition for being allowed into long distance. But so far, after five years, in only four states have the Bells opened up enough to qualify. Meanwhile, mergers have produced a re-monopolization – the eight regional monopolies that control 95 percent of the local telephone business (the "last mile") are now just four. Because the Bells won't cooperate in opening their networks (preferring to use the courts and politicians to foster delays), competitors called CLECs, or competitive local exchange carriers, are cutting back their service or are going bankrupt. Rates for consumers are high – the opposite of the condition that prevails in competitive long distance. It's not a pretty picture. To bust the bottleneck, the Telecom Act must be taken seriously and, at the same time, state public utilities commissions should be encouraged to force "structural separation" on the Bells, requiring them to split into independent wholesale and retail units, so that competitors will get a fair shake. It sounds technical but it is the only answer to liberating telecommunications supply, allowing interactive businesses (many of which are now going under for lack of broadband) to prosper, and spreading the benefits of fast Internet connections to consumers.

4. **Wireless, too, is being hurt by a lack of supply**. Regulators should get out of the business of allocating bandwidth to the politically powerful and instead let market forces determine who gets space on the spectrum. Congress should auction the spectrum that it gave for free to the TV broadcasters in return for a promise – unlikely to be met – of a timely buildout of digital, high-definition television. And the Defense Department must stop hogging bandwidth. The Federal Communications Commission has been sitting on loads of spectrum in the 700-megahertz frequency band. Liberate it.

These four simple changes are for starters. Clearly, the federal Air Traffic Control system is another constraint on supply – in this case, the supply of fast consumer and freight transportation – that needs to be eliminated and replaced by a private, market-oriented ATC, with government oversight for safety only. Occupational regulations reduce output by raising costs for businesses. All such rules must be reviewed verify that their benefits exceed their costs. And state governments must reduce the threats – especially to technology and energy -- inherent in the collusion between state attorneys general and trial lawyers, especially those hired on a contingency basis.

Conclusion

The U.S. economy has shown that, when supply is liberated, growth rates of 4 or 5 percent – roughly double the post-World War II average – are possible, *without* inflation. With tax cuts, interest-rate cuts, a supply-oriented energy policy and sensible regulations, we can revive a prosperity that will improve the lives of even more Americans than the boom of the 1980s and 1990s.